No. 17050

In the United States Court of Appeals for the Ninth Circuit

BAY COUNTIES TITLE GUARANTY CO. (FORMERLY BAY COUNTIES ESCROW CO.), PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 24-46) are reported at 34 T. C. 29.

JURISDICTION

This appeal involves income taxes for the calendar years 1952, 1953 and 1954. The Commissioner's notice of deficiency (R. 16-20) was mailed to the taxpayer on or about May 7, 1956 (R. 6, 16). Within 90 days thereafter, and on August 2, 1956, the taxpayer filed its petition with the Tax Court for redetermination under Section 272 of the Internal Rev-

enue Code of 1939 and Section 6213 of the Internal Revenue Code of 1954. (R. 3, 6-20.) The decision of the Tax Court that there is a deficiency in income tax for each of the taxable years 1952, 1953 and 1954 in the amounts of $2,068.80, $2,574.30 and $1,-924.71, respectively, was entered on April 12, 1960. (R. 46-47.) The case is brought to this Court by petition for review filed July 5, 1960. (R. 47-50.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court correctly sustained the Commissioner's determination that the amounts paid by the taxpayer, a title company, for starter reports and old policies on real estate titles should be treated as nondeductible capital expenditures rather than as ordinary and necessary business expenses which are deductible currently.

2. Alternatively, whether the taxpayer changed its method of accounting so as to require the advance consent of the Commissioner.

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra.*

STATEMENT

The material facts found by the Tax Court (R. 26-38) may be summarized as follows:

The taxpayer is a California corporation which keeps its books and reports its income on an accrual

basis. Taxpayer is an agent of the Pacific Coast Title Insurance Company of Los Angeles, hereinafter called "Pacific Title." Pacific Title is engaged in the title insurance business, being an underwriting company which issues policies of insurance on titles to real estate. (R. 26.)

The taxpayer conducts examinations and searches of title and then requests Pacific Title to issue insurance policies based upon such examinations. Taxpayer sells title insurance policies of Pacific Title and is the exclusive agent of Pacific Title in San Francisco County. Taxpayer is also an escrow company and attends to the closing of real estate transactions. It receives fees for its services in such matters. (R. 27.)

Taxpayer's title plant was acquired and accumulated during the five years 1947-1951. This plant includes maps of parcels and lots of real estate in San Francisco County; books of abstracts; tax assessor's ownership records; a complete set of Edwards Abstracts going back to 1908; also various records of searches and miscellaneous data. In carrying on its business, taxpayer uses its own basic records and, in addition, the city and county recorder's office records. (R. 27-28.)

Prior to 1952, the taxpayer capitalized all of its expenditures for real estate records; and by the end of 1951, the total cost of taxpayer's plant amounted to $25,000. In 1952, taxpayer had 34 employees, including 13 searchers and two examiners; the work of the searcher being to search and assemble material relating to titles and that of the examiner being to

write an abstract report and opinion. In general, before a policy of title insurance will be issued, it is necessary to make a complete search of the chain of title so as to determine whether a buyer will obtain a clear title. (R. 28-29.)

It is common for searchers and examiners to make use of previously prepared, or old, title reports as a starter, and then to bring the search up to date. If a starter report is available, it is unnecessary to make a complete search back to the earliest records; and frequently a starter report provides a title record up to a few years prior to the date of examination. A title examiner seldom retraces the search covered by a starter report; and these starter reports save time and expense in examining titles to real estate. (R. 29-30.)

There are four well-established title companies in San Francisco, and they have arrangements for reciprocal exchanges of information and data including starter reports. The taxpayer and Pacific Title are competitors of these four companies and are not entitled to participate in their reciprocal arrangements. (R. 30-31.)

Since taxpayer began business, it has followed the practice of obtaining copies of starter reports and old title policies from real estate concerns, real estate brokers, lending institutions and others. Sometimes taxpayer has made payments for such reports and policies, and sometimes it has obtained them free of charge. In most instances, payment is not made on the basis of individual copies, and lump sums are periodically paid for general accommodations. Pay-

ments are always made in cash. In this connection, payments of $6,896, $8,581 and $7,534 were made to real estate brokers in the taxable years 1952, 1953 and 1954, respectively. Those amounts were deducted as advertising expenses in taxpayer's income tax returns for those years. Neither the taxpayer nor its president, Rolls, who personally made the above payments, maintained any record showing the specific reports or policies to which the payments related. (R. 31-36.)

The bulk of the preliminary title reports and title policies which taxpayer purchased during the taxable years did not relate to any searches and examinations which it made in those years. Therefore, such documents were filed and indexed as a part of taxpayer's records for such future use, if any, as might develop. (R. 37.)

As above indicated, prior to 1952, taxpayer capitalized all payments for preliminary reports and old title policies; and for the first time, in 1952, 1953 and 1954, such payments were charged to current operating expenses and deducted in taxpayer's income returns. The Commissioner disallowed the entire amount of the deductions, $6,896 in 1952, $8,581 in 1953 and $7,534 in 1954. (R. 37.)

The Tax Court in sustaining the Commissioner specifically found and held (R. 37-38, 43-44) that the preliminary reports and old policies purchased by taxpayer in each taxable year had a useful life beyond the year of purchase, and the future time of use in taxpayer's business was problematic and indefinite depending upon when, as, and if taxpayer

might be called upon to make abstracts to the same pieces of property; in the circumstances, the reports and policies in question constituted additions and betterments to taxpayer's title plant, and the expenditures for them were nondeductible capital expenses and not ordinary and necessary business expenses.

SUMMARY OF ARGUMENT

I

The Tax Court made no error in holding that the amounts paid by taxpayer for starter reports and old policies of insurance on real estate titles were nondeductible capital expenditures and not ordinary and necessary expenses of doing business. The expenditures were made for items which constituted valuable additions to taxpayer's title plant and they were precisely within the definition of capital expenditures contained in long-standing Treasury Regulations to the effect that expenditures for items of plant, equipment, etc. which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account. The instant expenditures are different from amounts spent to obtain daily records which are treated as expense items since they are made currently to keep the plant in normal working order and are similar to incidental repairs. It is not always easy to draw the line between capital expenditures and expense items, but the Tax Court has correctly drawn the line in the instant case. This Court has held that it will rarely disturb the determination of

the trial court in a case of this character (*United States* v. *Times-Mirror Co.*, 231 F. 2d 876); and we submit that there is no adequate basis for disturbing the decision of the Tax Court here. It is not of critical importance whether depreciation or obsolescence deductions may be taken with respect to the additions to taxpayer's title plant, for the true test of a capital expenditure is the nature of the expenditure in and of itself. It is obvious that an expenditure for land would be capital in character and not a deductible item of expense even though no depreciation deductions could be taken with respect to the land. The decision of the Tax Court herein is in accord with the law and the Regulations, sustained by the record and should therefore be upheld by this Court.

II

In any event, taxpayer would be required to obtain the Commissioner's consent in order to treat the instant items as deductible business expenses, since it capitalized all such items in prior years. The applicable Regulations (Treasury Regulations 118, Section 39.41-2) provide that a taxpayer can not change its accounting method for tax purposes without the advance consent of the Commissioner; and the term "accounting method" is broad enough to embrace not only over-all methods such as the cash and accrual methods, but also the accounting treatment of items of income or deductions. Here the taxpayer is attempting to make a material change in its accounting method without the Commissioner's consent, and we submit that this can not properly be done.

ARGUMENT

I

The Amounts Paid by Taxpayer for the Starter Reports Constitute Capital Expenditures and Not Business Expenses

In determining the deficiency herein, the Commissioner held (R. 18-19) (1) that the payments in question were in fact rebates of escrow fees made in violation of California law and (2) in the alternative the payments were capital expenditures which could not properly be expensed. In his Tax Court brief, the Commissioner withdrew his first contention and stood on his alternative contention plus a further point that in any event taxpayer could not change its method of accounting without the advance consent of the Commissioner. As above indicated, the Tax Court upheld the determination that the payments were capital expenditures (R. 43) and in view of that disposition the Tax Court did not need to pass upon the further contention that the taxpayer sought to change its method of accounting without first obtaining the consent of the Commissioner. (R. 46.)

We will adhere to the position of the Commissioner as taken in his Tax Court brief; and we submit that the court below made no error in sustaining his determination that the expenditures in question were capital expenditures and not ordinary and necessary expenses of doing business. It has long been settled that expenditures made during the year should be properly classified as between capital and expense; and expenditures for items of plant, equipment, etc.

which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account. Treasury Regulations 118, Section 39.41-3 (Appendix, *infra*).[1] And see also *Crocker First Nat. Bank* v. *Commissioner*, 59 F. 2d 37 (C. A. 9th); *Schwabacher* v. *Commissioner*, 132 F. 2d 516 (C. A. 9th); *A. Giurlani & Bro.* v. *Commissioner*, 119 F. 2d 852, 857-858 (C. A. 9th); *Parkersburg Iron & Steel Co.* v. *Burnet*, 48 F. 2d 163 (C. A. 4th); *Russell Box Co.* v. *Commissioner*, 208 F. 2d 452 (C. A. 1st); *P. Dougherty Co.* v. *Commissioner*, 159 F. 2d 269 (C. A. 4th), certiorari denied, 331 U. S. 838; *Mt. Morris Drive-In Theatre Co.* v. *Commissioner*, 25 T. C. 272, affirmed, 238 F. 2d 85 (C. A. 6th); *Stoeltzing* v. *Commissioner*, 266 F. 2d 374 (C. A. 3d); *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, 279 F. 2d 368 (C. A. 10th); 4 Mertens, Law of Federal Income Taxation (1954 ed.), Section 25.20; cf. *United States* v. *Times-Mirror Co.*, 231 F. 2d 876 (C. A. 9th); *W. B. Harbeson Lumber Co.* v. *Commissioner*, 24 B.T.A. 542.

The Commissioner's determination is presumptively correct and the taxpayer has the burden of overcoming the presumption. *Welch* v. *Helvering*, 290 U. S. 111, 115; *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (C. Cls.). The basic question is largely

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[1] The relevant provisions of Sections 23(a)(1)(A) and 24(a) of the Internal Revenue Code of 1939 and Sections 39.23(a), 39.24(a) and 39.41-3 of Treasury Regulations 118 are set out in the Appendix, *infra*; see also Sections 162(a) and 263(a) of the Internal Revenue Code of 1954 and Sections 1.162-1, 1.162-4 and 1.263(a) of the Treasury Regulations on Income Taxes (1954 Code).

on of fact and the finding of the trial court will not be reversed in the absence of clear error. *United States* v. *Times-Mirror Co., supra; P. Dougherty Co.* v. *Commissioner, supra.* There was no clear error in the instant case; and quite to the contrary the decision appears to be correct and amply supported by the record.

In this connection it will be noted that for the entire period from the date of taxpayer's incorporation (1946) until 1952 (the first taxable year here involved) all expenditures of the instant type were capitalized and no deductions were taken in taxpayer's income tax returns. In 1952 taxpayer began to treat such payments as expense items and took deductions in its income tax returns for the first time. (R. 37, 114-115.) Taxpayer did not obtain the consent of the Commissioner before making this change in its accounting procedures, and this matter will be more fully discussed in the next section of this brief. That point will become material only if this Court should disagree with the Tax Court and ourselves as to the payments being capital expenditures which cannot properly be deducted as business expenses.

In the instant case, the Tax Court after carefully considering the complete record concluded (R. 44) that "it is clear beyond any doubt that the starter reports have an economic life extending beyond the year of purchase and that they represented additions and supplements to the plant which increased its value." It has long been recognized that expenditures of this character should be charged to the capital account; and they are to be distinguished from ex-

penditures of a recurring nature where the benefit derived from the payment is realized and exhausted within the taxable year. O.D. 1018, 5 Cum. Bull. 119 (1921); O.D. 1049, 5 Cum. Bull. 175 (1921); I.T. 1775, II-2 Cum. Bull. 145 (1923); *Record Abstract Co.* v. *Commissioner*, 2 B.T.A. 628 (1925); *Cuyahoga Abstract Title & Trust Co.* v. *Commissioner*, 7 B.T.A. 95, affirmed, 29 F. 2d 448 (C.A. D.C.), certiorari denied, 279 U. S. 848 (1928). Since a title plant is not an asset of a nature which gradually approaches a point where its usefulness is exhausted, but is an asset of a more or less permanent character, it has been held not to be a proper subject for depreciation (O.D. 1018, *supra*); but obsolescence allowances may be taken in some cases and the cost of the plant less the salvage value thereof spread equally over the period from the date the permanent abandonment of the plant was foreseen to the date of the permanent abandonment. I. T. 1775, *supra; Crooks* v. *Kansas City Title & Trust Co.*, 46 F. 2d 928 (C. A. 8th); *Stewart Title Guaranty Co.* v. *Commissioner*, 20 T. C. 630; *Commonwealth Title Co.* v. *Rothensies*, 124 F. Supp. 274, 286 (D.C. Penna.); cf. *Real Estate Title Co.* v. *United States*, 309 U. S. 13. In the present case, however, there is no contention as to obsolescence; and the fundamental question is whether the taxpayer's outlays for starter reports and old title policies may properly be expensed instead of being added to the title plant subject to obsolescence deductions.

In the Tax Court, the taxpayer relied heavily upon O.D. 1018, *supra*, which states that "the expense of

adding and incorporating in the plant records that are being made daily in the various courts and in the Recorder's office" are in the nature of ordinary and necessary repairs which are deductible currently. In this connection the Tax Court ruled that the expenditures for starter reports and old title policies which taxpayer here seeks to deduct are not the kind of expenses referred to in the ruling. The Tax Court said (R. 44-45):

> Petitioner incurs the kind of expense described in the cited ruling by its continuous subscription to Edwards Abstracts which furnishes such daily records of the courts and the Recorder's office in San Francisco County. The expense under consideration here of purchasing starter reports is not the same and is distinguishable from the kind of expense described in the ruling. A starter report covers a search and examination of title and while it does not have the coverage of a completed abstract, it is within the same general category. O. D. 1018 does not refer to reports on title.

We submit that the Tax Court made no error and the distinction that it drew is a proper one.

In this Court, the taxpayer renews (Br. 15-17, 22) its reliance upon O. D. 1018 and says that the starters should be treated in the same manner as the daily records and that the distinction drawn by the Tax Court is unsound. We disagree and submit that the taxpayer overlooks the practical considerations which underlie the distinction. The situation is analogous to the costs of a set of law books. A lawyer acquiring at one time a full set of the United States Reports

purchases a capital asset subject to depreciation. Thereafter, as he purchases its current volumes, it is more practical to permit the current year's costs to be deducted instead of amortized for the computations would become too complicated and the net tax result would not be sufficiently different to justify these complications. The instant situation is also somewhat analogous to the distinction between the cost of building a newspaper's circulation structure, which is a capital expense (*Meredith Pub. Co.* v. *Commissioner*, 64 F. 2d 890 (C. A. 8th), certiorari denied, 290 U. S. 646; *Public Opinion Pub. Co.* v. *Jensen*, 76 F. 2d 494 (C. A. 8th)), and the expense of maintaining the circulation, which is currently deductible (*Perkins Bros. Co.* v. *Commissioner*, 78 F. 2d 152 (C. A. 8th); *Willcuts* v. *Minnesota Tribune Co.*, 103 F. 2d 947 (C. A. 8th), certiorari denied, 308 U. S. 577). This distinction was referred to by this Court with approval in *United States* v. *Times-Mirror Co.*, *supra*, 231 F. 2d at page 880. And while the law as to deductibility of circulation expenditures has been changed to some extent by Section 23(bb) of the Internal Revenue Code of 1939 and Section 173 of the Internal Revenue Code of 1954, still, those changes do not affect the basic soundness of the distinction above referred to, and they serve to emphasize the validity of that distinction where no statutory changes have been made. And see 4 Mertens, Law of Federal Income Taxation (1954 ed.), Section 25.23.

Taxpayer says (Br. 17) that it could obtain starter reports by the more expensive method of hiring title searchers to prepare them and if it did this the sal-

aries of the searchers would constitute a deductible expense. In this connection taxpayer refers to a recent decision of the Court of Claims (*General Motors Corp.* v. *United States*, decided November 2, 1960 (60-2 U.S. T.C., par. 9762)) where it was held that the corporation could deduct as a business expense the amount of certain taxes for which the various stockholders were liable, since it would cost more to calculate their respective shares of such taxes and deduct them from dividends than it would to absorb the taxes as the corporation did. Irrespective of whether this decision of the Court of Claims can be considered correct, it has little if any bearing on the instant situation where we are dealing with the purchase of property for use in the taxpayer's business and which had a useful life extending far beyond the taxable year. Such an asset does not differ materially from machinery or fixtures which are used in a business, and certainly the cost of such acquisitions should be capitalized. And assuming *arguendo* that the instant taxpayer possibly could have achieved its objectives by a different form of business dealing, that does not help it here, for the Commissioner is justified in determining the tax effect of transactions on the basis in which taxpayers have molded them. *Television Industries, Inc.* v. *Commissioner* (C. A. 2d), decided November 14, 1960 (60-2 U.S. T.C., par. 9795); *Gray* v. *Powell*, 314 U. S. 402, 414; *Founders General Co.* v. *Hoey*, 300 U. S. 268, 275; *Higgins* v. *Smith*, 308 U. S. 473, 477; *Interlochen Co.* v. *Commissioner*, 232 F. 2d 873, 877 (C. A. 4th); *Woodworth* v. *Commissioner*, 218 F. 2d 719, 724 (C. A. 6th).

And see *Ratterman* v. *Commissioner*, decided July 6, 1948 (1948 P-H. T.C. Memorandum Decisions, par. 48,130), affirmed, 177 F. 2d 204 (C. A. 6th), where it was held that the expenditure for a dictaphone, in lieu of compensation for a stenographer's services, was not deductible as a business expense and constituted a capital expenditure.

The taxpayer refers (Br. 19-20) to *Consolidated Apparel Co.* v. *Commissioner*, 17 T. C. 1570, reversed in part on other issues, 207 F. 2d 580 (C. A. 7th), where an amount subscribed and paid during the taxable year to a development and advertising association of merchants in taxpayer's business district was held deductible in full as a business expense of that year even though some future benefits might possible ensue to the taxpayer. That case falls within the scope of the rule that where the expenditures constitute a part of a continued plan of advertising in order to keep constantly before the public the product which the taxpayer is manufacturing, the expenses should ordinarily be deducted in the year of payment notwithstanding that there may be involved some element of resulting good will. See 4 Mertens, Law of Federal Income Taxation (1954), Section 25.38. In the instant case the situation is different, for here the taxpayer made additions to its title plant which have long been treated as capital acquisitions.

Taxpayer also refers (Br. 20-21) to *E. H. Sheldon & Co.* v. *Commissioner*, 214 F. 2d 655 (C. A. 6th), where the court held that the cost of certain catalogs used to advertise the taxpayer's products was de-

ductible as advertising expense in the year of payment notwithstanding the fact that the catalogs would have a useful life in excess of one year. That case is of doubtful correctness, particularly since the appellate court reversed the Tax Court (an action which was disapproved in *United States* v. *Times-Mirror Co., supra*); but in any event it is distinguishable on the ground that the payments there could reasonably be classified as advertising whereas those here can not. The instant payments were made for additions and supplements to taxpayer's title plant and such expenditures have long been treated as capital in nature, as we have pointed out above.

Taxpayer also cites (Br. 21) *Collingwood* v. *Commissioner*, 20 T. C. 937, where the Tax Court in an opinion written by the same judge who decided the instant case held that certain payments made for terracing work on farm lands were deductible as business expenses since nothing was added to the soil and the work was done in order to overcome erosion and thus maintain the productivity of the farms in normal and customary operation. That case differs from the instant one where permanent additions to the plant facilities were made for future use in the business when the occasion might arise. And see *RKO Theatres, Inc.* v. *United States, supra*, 163 F. Supp. at page 601.

Taxpayer states (Br. 22) that no depreciation of the title plant is allowable as a deduction; but taxpayer makes no mention of the fact that the plant is subject to obsolescence deductions. See *Stewart Title*

Guaranty Co. v. *Commissioner, supra;* 4 Mertens, Law of Federal Income Taxation (1954 ed.), Section 23.115.

Moreover, even if no depreciation or obsolescence deductions could ever be taken, it would make no difference here for the true test is the nature of the expenditure in and of itself. *Parkersburg Iron & Steel Co.* v. *Burnet, supra.* Thus an expenditure for land is clearly capital in nature even though no depreciation deductions can be taken. *Brand* v. *Commissioner*, 209 F. 2d 255 (C. A. 6th), certiorari denied, 347 U. S. 968. Here the expenditures resulted in a practically everlasting addition to the plant facilities and they were precisely within the definition of capital expenditures in Section 39.41-3 of Treasury Regulations 118, referred to above, to the effect that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year, should be charged to a capital account and not to an expense account. These provisions have been in the Regulations for many years and have therefore acquired the force of law. *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Schwabacher* v. *Commissioner, supra.*

In view of the foregoing we submit that the findings and conclusions of the Tax Court are sound and correct in all respects, and we urge this Court to uphold them.

II

In the Alternative, Taxpayer Is Not Entitled to Change Its Accounting Method Without First Obtaining the Commissioner's Consent

Section 41 of the Internal Revenue Code of 1939 (Appendix, *infra*) provides that the net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer; but if no such method has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. Treasury Regulations 118, Section 39.41-2 (Appendix, *infra*), provide that a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. This regulation is designed to promote consistent accounting practice from year to year. The regulation is reasonable and valid (*St. Paul Union Depot Co.* v. *Commissioner*, 123 F. 2d 235 (C. A. 8th); *Pacific Vegetable Oil Corp.* v. *Commissioner*, 26 T. C. 1, reversed on another issue, 251 F. 2d 682 (C. A. 9th)); and indeed it has been codified in Section 446 of the Internal Revenue Code of 1954 (see 2 Mertens, Law of Federal Income Taxation (1955), Section 12.19). See also Treasury Regulations on Income Taxes (1954 Code), Section 1.446-1.

And where the Commissioner denies an application for permission to change the taxpayer's method of

accounting for purposes of taxation, the only question before the court on review is whether the Commissioner has abused his discretion. *Brown* v. *Helvering*, 291 U. S. 193, 204-205;[2] *United States Industrial Alcohol Co.* v. *Helvering*, 137 F. 2d 511 (C. A. 2d); *Advertisers Exchange, Inc.* v. *Commissioner*, 25 T. C. 1086, affirmed, 240 F. 2d 958 (C. A. 2d); *Schram* v. *United States*, 118 F. 2d 541 (C. A. 6th); cf. *Idaho First National Bank* v. *United States*, 265 F. 2d 6 (C. A. 9th).

In the instant case, the taxpayer capitalized all payments of the instant character prior to 1952 (R. 28, 37); and in the latter year, it began to treat such payments as expense items and took deductions in its income tax returns for the first time (R. 37, 114-115), as we have pointed out above. Taxpayer did not request nor obtain the consent of the Commissioner before making this change in its accounting method; and the Commissioner has at no time given his consent thereto. It follows that even if this Court should determine, contrary to our views and those of the Tax Court, that the payments in question could properly be treated as deductible business expenses, still, taxpayer is not at liberty to change its long-

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[2] The court there said—

> "The Commissioner was of opinion that the method of accounting consistently applied prior to 1923 accurately reflected the income. He was vested with a wide discretion in deciding whether to permit or to forbid a change. Compare *Bent* v. *Commissioner*, 56 F. 2d 99. It is not the province of the court to weigh and determine the relative merits of systems of accounting. *Lucas* v. *American Code Co.*, 280 U. S. 445, 449."

standing practice of capitalizing such payments since it did not obtain the Commissioner's advance consent as required.

It seems clear that there would be no abuse of discretion on the part of the Commissioner in refusing to permit the taxpayer to change its accounting method in the instant case; and the term "accounting method" is broad enough to embrace not only overall methods such as the cash and accrual methods, but also the accounting treatment of items of income and expense. Thus, Treasury Regulations 118, Section 39.41-2, specifically refers to any change in items of income or deductions. And the Treasury Regulations on Income Taxes (1954 Code), Section 1.446-1, specifically mentions a change in the treatment of a material item. In the instant case, the taxpayer is attempting to make such a change, and therefore the consent of the Commissioner would be required in any event. See *Advertisers Exchange, Inc.* v. *Commissioner*, *supra*.

In the light of the foregoing considerations we submit that the determination of the Tax Court that the payments here involved were capital expenditures should be upheld by this Court.

CONCLUSION

The decision of the Tax Court should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Sec. 24. Items Not Deductible.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;

* * * *

(26 U.S.C. 1952 ed., Sec. 24.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.23 (a)-1 *Business expenses.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly

connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than subsection (a) of section 23. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23 (a), see § 39.23 (a)-13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See § 39.22 (a)-5. Amoung the items included in business expenses are management expenses, commissions (but see § 39.24 (a)-2), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 39.23 (a)-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though

such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

* * * *

SEC. 39.23(a)-4 *Repairs.* The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept.

SEC. 39.24 (a)-2 *Capital expenditures*—(a) *Expenditures except non-depreciable mine development expenditures.* Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. See section 23(l). Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. * * *

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SEC. 39.41-2 *Bases of computation and changes in accounting methods.* * * *

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(c) A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 39.22 (c)-1 to 39.22 (c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 39.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 39.22 (a)-7 and 39.23 (a)-11). Application for permission to change the method of accounting employed and the basis upon which the return is made shall be filed within 90 days after the beginning of the taxable year to be covered by the return. The application shall be accompanied by a statement specifying the classes of items differently treated under the two methods and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. Permission to change the method of accounting will

not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. * * *

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SEC. 39.41-3 *Methods of accounting.* * * *

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(b) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(c) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

The corresponding provisions of Sections 162(a), 263(a) and 446 of the Internal Revenue Code of 1954; and Sections 1.162-1, 1.162-4, 1.263(a) and 1.446-1 of the Treasury Regulations on Income Taxes (1954 Code) do not differ from the above in any material respect.

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